HSBC Global Research

13 May 2022

Repeating exceptionals

Identifying outliers amongst the noise of non-GAAP earnings

Free to View
ESG - Global

- Our data science and forensic accounting methodology prioritises which companies' adjustments appear "large"
- Considering these accounting choices can provide valuable insight to investors
- We re-run our 2021 analysis on the FTSE100, FTSE250, STOXX600 and JSE140

Dylan Whitfield, FCA
Head of Forensic Accounting
HSBC Bank plc

Mark McDonald
Head of Data Science and Analytics
HSBC Bank plc

Rahul Chopra*
Analyst
HSBC Securities and Capital Markets (India) Private Limited

** Employed by a non-US affiliate of HSBC Securities (USA) Inc, and is not registered/ qualified pursuant to FINRA regulations*

Why we think investors should look at adjustments
The use of exceptional items or "adjustments" to earnings by companies is widespread. Companies have total discretion on how to define these non-GAAP "adjusted" metrics, which are almost more positive than the IFRS numbers. But, considering what a company has invited one to ignore can be valuable. We think adjustments may alert investors to companies that:

- may be under financial pressure, e.g. potentially under recognising costs;
- are trying to set the scene for a future narrative;
- have over-valued assets (that perhaps should have been written down previously) in order to provide a lower capital employed value; and
- may be taking provisions to provide a buffer to reverse in future years.

Our unique combined data science and forensic accounting approach
In 2021 we developed an approach to prioritise the companies where a closer look at exceptional items may be required. **Our "Non-linear Combination Score" ("NLCS")** method provides a relative scoring rating of the size of the adjustments made by each company with reference to the size of those adjustments compared to a company's individual captions (e.g. Revenue or EBITDA).

We rerun our 2021 analysis on the FTSE100, FTSE250, STOXX600 and JSE140
Although individual companies moved, at an index level there was, unfortunately, still a substantive level of adjustments, again the majority being additive. We found 575, (61%) of companies reported net additive adjustments and 46 of companies in all four indexes had adjusted items that were in excess of 50% of average adjusted EBITDA.

Our forensic accountant's approach to considering individual adjustments
We revisit our forensic accounting approach to considering exceptional items on a granular level having used our method to prioritise which to look at.

This is a Free to View version of a report with the same title published on 13-May-22. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

Issuer of report: HSBC Bank plc

View HSBC Global Research at:
https://www.research.hsbc.com

Outliers from the normal "unusual" items

- Companies have complete latitude in defining "adjusted" metrics. They are widely used and almost always present a "rosier" picture than the straightforward GAAP numbers.
- Considering these elective accounting choices can provide valuable insight to investors.
- Our data science and forensic prioritisation approach prioritises which companies may have levels of adjustment that warrant a closer look.

Why we look at the use of exceptional items

Over reliance on "adjustments" can be a subtle sign

Subtle signs can be more useful than looking for a "red flag"
When attempting to identify issues and risk from an accounting perspective, there is no single "red flag" or test to determine when there might be an issue. Often when a problem gets to the point that it becomes obvious from an outsider's perspective it is often too late to do anything about it. We therefore prefer to look for subtle signs of risk or concern. We often focus our attention on areas that are subject to subjectivity, estimation or accounting choice.

Adjustments and exceptional items are one such area (as management can define these for themselves) and considering what the management of a company suggests one should ignore is often worth the effort.

In our view, understanding the adjustments and exclusions being made by companies can alert investors to:

- **companies that may be under financial pressure:** potential under recognition or deferral/moving of costs out of "underlying" (e.g. a capitalisation of costs then writing off/amortising or perhaps over-optimistic assumptions for write-downs) and into exceptional items could provide a more flattering picture of "underlying" / or "recurring" earnings;
- companies looking to manage the narrative (e.g. rebasing numbers to deliver "growth") by, for example:
  - over-recognising costs (either in exceptional or underlying) in the current year in order to provide a **lower cost base/higher margins/better growth rates in subsequent years**;
  - writing down assets in the current year (that perhaps should have been written down previously) for example to provide **a lower capital employed in subsequent years**; or
  - taking provisions to provide a buffer to reverse in subsequent years;
- **a selective accounting posture** (which could extend beyond the exceptional items); and
- issues in relation to the financial control and governance of a company.

However, we stress that while large exceptional items MAY be indicators of the above there are, in many instances, good reasons for large adjustments (and these are often helpful to investors). Therefore, for the avoidance of doubt, we advocate a granular analysis before drawing any inferences or conclusions.

By any measure, distributable reserves do not equal "adjusted" EBITDA

Assuming "adjusted" results drop through to distributions may be a risky assumption

We also advise caution when considering adjusted metrics because distributions (i.e. dividends and returns of capital) will ultimately come out of (some form of) profits after all expenses. Therefore, despite all the plausible rationale provided by company management that "adjusted" is a better reflection of the performance of the business, unadjusted profits are what may ultimately be due to shareholders via distributions.

As we set out in *Accounting for dividends (15 Feb 2022)*, although there are different rules for what profits are available for distribution to those disclosed as consolidated profits, we think that it is fair to say that in most (although not all) scenarios profits recognised each year into retained earnings are likely to be closer to what is distributable than any non-GAAP measures such as "adjusted" EBITDA, and adjusted EPS although, again it is not that simple and there can be significant divergences.

Consequently, we think that non-GAAP measures, although sometimes helpful, should be treated with care and scepticism, and the **unadjusted** earnings should, in most cases, be given at least equal weight when considering the financial performance of a company.

Updating our work – although there are still impacts of disruption, there are still the "normal" levels of exceptional items to consider

Getting back to "normal" i.e. still significant adjustments

We re-run our analysis for the latest numbers

Last autumn we set out our combined data science and forensic accounting approach to consider the level of adjustments (or "exceptional items") that companies are making to their earnings in order to prioritise which companies within an index may warrant a closer look.

In that report, we set out the result of that analysis on companies the FTSE100, FTSE250, STOXX600 and JSE140 indices, and highlighted companies that appeared to be making greater, more regular use of exceptional items.

Getting back to "normal", but is "normal" the right answer?

Although our previous (and most likely our more recent) analysis likely include some of the effects of COVID-19 related adjustments, the level of use of exceptional items (usually additive) by companies is, unfortunately, widespread even in a "normal" year.

We have demonstrated in previous reports that such items are often material and in one direction (i.e. additive to earnings). We think that the previous chairman of The International Accounting Standards Board (the "IASB") summed up the issue perfectly:

> **"For some reason, companies often find it much easier to find unusual expenses than unusual items of income. It is the main reason why 80%–90% of non-GAAP measures present a rosier picture than numbers reported using IFRS."**
>
> **Hans Hoogervorst, (previous) IASB Chairman**

Therefore, it comes as no surprise to find again that a significant number of companies are using large adjustments to adjust up their earnings.

Full details of our analysis can be found in the main research report available to clients of HSBC Global Research, including a discussion on why despite performing a granular analysis is key, it must be prioritised by considering the relative size of exceptional items to various factors – and why we use data science to perform these tasks. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

A forensic approach for considering exceptional items

After prioritisation comes the granular work

Having prioritised the companies for further analysis, what might that analysis be?
As with much accounting analysis, there is no "standard" approach for identifying issues with exceptional items. We have set out below a list of questions that investors may find helpful. These questions are not intended to be exhaustive, nor are they specific to a particular company. Rather, we suggest these as a starting point that can be used in conjunction with a healthy level of scepticism to consider these items, which should also ideally be triangulated to other information where possible.

Questions investors should consider

1. **What narrative is the company trying to present?**
2. **What metrics are being presented (or are important to stakeholders) and how do the exceptional items affect those metrics?**
3. **Is there a possibility that directors' remuneration and incentives are driving accounting estimates?**
4. **What opportunities might the company have or use in order to move costs around?**
5. **Where a company has recognised exceptional items or additional costs due to disruptions:**
   a. is there a clear linkage between "cause and effect";
   b. has the company been "*even-handed in identifying any gains as well as losses"*;
   c. are there any indications that the costs may not be one-off; and
   d. do write downs and impairments make sense individually and collectively?
6. **What subjective accounting judgements and estimates has the company made? Do these make logical sense and are they consistent with the wider environment?**
7. **Have there been any significant changes in the accounting choices and judgements during the period?**
8. **What assumptions are the company using and are those consistent across the accounts, with peers and in the wider economic environment?**
9. **Have any specific risks been identified by the audit committee and/or the auditor in relation to these balances?**
10. **Considering the accounting for costs as a whole, are there indications of selective accounting which may be an indicator of wider financial reporting governance concerns?**

Conclusion

The use of exceptional items has not reduced significantly. Although that is not surprising, what did spark our interest was the level of their use had not seemed to materially improve. Although this is potentially the tail end of the impact of COVID-19 disruptions that were still being felt in the year end numbers, we would have expected there to have been a marked reduction. Perhaps this will come in the next half year results. It remains to be seen.

Despite the disruptions, the volume and magnitude of adjustments still appears to be significant. Whilst frustrating to analyse (e.g. deciding which ones to add back in) we think that it does provide the more detailed focused investor to gain a potentially advantageous insight into the company's financial posture and governance.

Disclosure appendix

The following analyst(s), who is(are) primarily responsible for this document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Dylan Whitfield, FCA, Mark McDonald and Rahul Chopra

This document has been issued by the Research Department of HSBC.

HSBC and its affiliates will from time to time sell to and buy from customers the securities/instruments, both equity and debt (including derivatives) of companies covered in HSBC Research on a principal or agency basis or act as a market maker or liquidity provider in the securities/instruments mentioned in this report.

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking, sales & trading, and principal trading revenues.

Whether, or in what time frame, an update of this analysis will be published is not determined in advance.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at www.hsbcnet.com/research.

Additional disclosures

1 This report is dated as at 13 May 2022.

2 All market data included in this report are dated as at close 11 May 2022, unless a different date and/or a specific time of day is indicated in the report.

3 HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking, Principal Trading, and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.

4 You are not permitted to use, for reference, any data in this document for the purpose of (i) determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments, (ii) determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument, and/or (iii) measuring the performance of a financial instrument or of an investment fund.

Disclaimer

[1192657]